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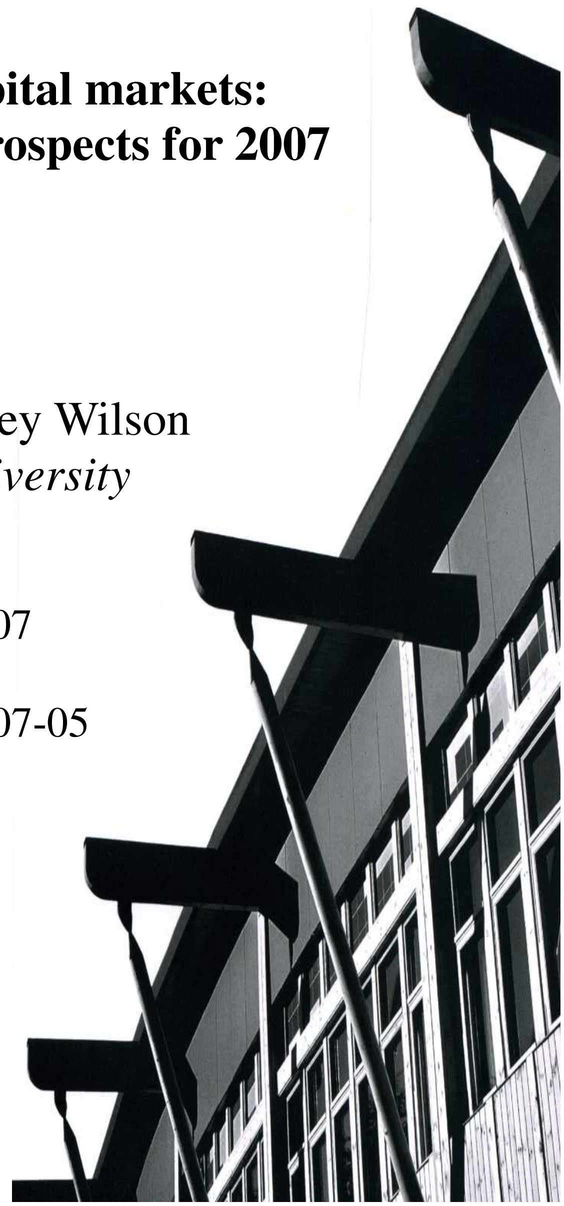
Global Islamic capital markets: review of 2006 and prospects for 2007



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Global Islamic capital markets: review of 2006 and prospects for 2007

The last year witnessed mixed results from Islamic capital markets, usually defined as including the issuance and trading in equities that are *shariah* compliant and Islamic *sukuk* securities. The conventional equivalents are equity and bond markets and the institutions that invest in these markets, namely investment banks, managed funds and insurance companies.

Shariah compliant equity investments

Just because securities are *shariah* compliant does not imply that they necessarily under perform or out perform conventional market instruments, and in 2006 there was little sign of significant divergence between the returns on *shariah* compliant assets and their conventional equivalents, and it is unlikely that there will be much divergence in 2007. Specifically with equity investments, the major factor explaining the differences between the performance of the Dow Jones Islamic Indices and their mainstream indices is the performance of the shares of conventional banks, as other shares screened out such as those of brewers and distillers are not significant enough to affect the markets. Generally if conventional bank shares do well, *shariah* compliant investors loose out, but if they fare less well, *shariah* compliant investors do better. Globally 2006 was a good year for bank shares, but by no means outstanding, and therefore *shariah* screening made little difference to performance.

Of greater significance for *shariah* compliant equity investment was the performance of the home markets of the investors. Following the Gulf equity markets boom of 2003-2005, price-earnings ratios became distorted, and it became obvious to most observers that a significant correction was likely, even if its timing could not be easily predicted. The inevitable downturn came in February and March, with Gulf markets loosing almost half their value over the remainder of the year. Saudi Arabia in particular, the largest equity market in the Islamic world in terms of capitalization, fared especially badly, with most investors losing substantial amounts. Islamic managed funds focused on local market investments could not escape the downturn, and all suffered capital depreciation in 2006.

Despite the setback in Gulf stock markets, the more prudent *shariah* compliant investors, with diversified international portfolios were only marginally affected. Indeed many saw the correction coming, realized their gains, and looked to invest elsewhere, especially in Asian markets, although there was also some move into Euro denominated stock, encouraged by concerns with the depreciation of the US dollar. It was therefore a good year for marketing *shariah* compliant funds focused on Europe and Asia to Gulf investors who in 2005 viewed such markets unfavorably given the phenomenal returns in their own home markets.

The wider impact of the stock market correction in the Gulf appears to have been limited, partly because of continuing high oil prices, as GDP growth in Saudi Arabia again exceeded 6.5 percent, with the figure for the UAE being nearer 10 percent, and the economy of Dubai growing significantly faster. As a consequence private wealth continued to grow rapidly, including that of those high net worth families who have a strong preference for *shariah* compliant investment. Although oil prices are expected to be lower in 2007, with an inevitable slowing down in GDP growth rates in the Gulf, any impact on private wealth is likely to be marginal, which should mean another good year for private bankers focusing on Islamic investors of high net worth.

Although many Gulf Islamic investors appear to have an appetite for risk, the stock market correction has resulted in some seeking capital protected products, which raises challenging *shariah* compliance issues. There can of course be no guarantee for investment *mudarabah* deposits with Islamic banks or conventional banks offering Islamic "windows", as the aim of *mudarabah* contracts is to justify reward through risk sharing. For equity investments there are no contractual obligations after the initial share purchases, the risk being entirely borne by the investor rather than shared with entrepreneurial partners. Consequently seeking capital protection in equity markets can be viewed as permissible, including even the use of derivatives to provide the protection, as the *shariah* concern is with trading derivatives far removed from the underlying assets.

Purchasing a "put" option with the intention of buying the stock can be compared with the Islamic contract of *arboun*, a deposit for the delivery of a specified quantity of a commodity on a pre-determined date. The new *shariah* compliant capital protected funds offered in 2006 all referred to *arboun* contracts. Options and futures contracts cannot be traded under *shariah*, as they are too remote from the underlying assets, but that is not to say they cannot be purchased with the investor enjoying a constant, if not increasing, financial reward. The central issue is the nature of the contracts themselves, There is inevitably a relationship between risk and return, which Islam does not see as problematic, but rather an inevitable consequence of the real world with its business cycles. The concern in Islam is with *gharar,* contractual uncertainty, but not with trying to eliminate other uncertainties, such as those in equity markets, which are inevitably a fact of life.

Islamic securities markets

Trading in *sukuk* or Islamic securities was largely confined to Kuala Lumpur until recently, but the last year has seen the start of significant *sukuk* trading in the Gulf, a development that is likely to become of increasing importance in 2007, as Dubai and Bahrain compete to become the leading global market, Kuala Lumpur's potential role being limited by the *sukuk* being local currency denominated, which deters international investors. *Sukuk* are the *shariah* compliant counterpart of conventional bills, floating rate notes and bonds, the pre-requisites for *shariah* acceptability being that they must be asset backed and structured using an Islamic financing instrument so that there are no *riba* payments. The most popular, and standardized structure is based on *ijara* contracts, which makes the *sukuk* equivalent to a floating rate note in terms of its financial characteristics. The majority of new *sukuk* issuance in 2006 was of this type, the main alternative being *salam* and *murabahah sukuk* which yield a fixed return, the former, typically for three months, corresponding to a treasury bill, while the latter, usually running from 3 to 7 years, corresponds to a bond. It was the Bahrain Monetary Authority, renamed as the Central Bank of Bahrain in 2006, that pioneered *salam sukuk* five years ago, and in 2006 there were two further offerings worth $40 million each, and paying 2.34 percent, a similar rate to that on its conventional treasury bills.

Sukuk issuance has increased substantially over the last six years, and 2006 was a record year, with over 170 new *sukuk* issues worth over $27 billion. The year started with the then world's largest ever *sukuk* worth over $3.5 billion, the issuer being the Dubai Ports Authority and DPI Terminals and the managers being Dubai Islamic Bank and Barclays Capital. This was to finance Dubai Ports' take-over of P&O Ports worldwide interests. The *sukuk* was based on an innovative *musharakah* structure, with the investors receiving certificates of partnership, giving then a pre-determined share of any profits or losses, the actual profit distribution being linked to performance indicators. Hitherto most of the large *sukuk* issues had been managed by international banks such as HSBC Amanah and Citigroup, but Dubai Islamic Bank has tried to diversify beyond its retail banking business in recent year, and this deal marked a turning point in its investment banking operations. Partly as a result of its business diversification strategy, Dubai Islamic Bank enjoyed a 26 percent rise in profits in 2006, with gross profits amounting to $600 million, and the value of its assets rising to over $14 billion. Net profits after dividends to shareholders and profit sharing with depositors rose to $280 million, and the attractive product offerings to customers resulted in a 60 percent rise in deposits to $11.24 billion.

Subsequently Dubai Islamic Bank was able to build on its experience as a *sukuk* manager to win the mandate later in the year, again with Barclays Capital, for the largest ever *sukuk*, that issued by the Nakheel Group of Dubai, the second largest construction and development group in the Middle East after Emaar, also of Dubai. The Nakeel Group *sukuk* was valued at $3.52 billion, with an *ijara* structure used and the variable returns benchmarked to LIBOR, as is usual with *ijara sukuk,* the actual return being LIBOR plus 120 basis points. However to make the financing cheaper for Nakheel, and to add an incentive for investors, holders of the *sukuk* certificates will have the right to buy shares at a discount in any Nakheel Group initial public offering (IPO). As the Nakheel Group is developing the Palms, there is likely to be an IPO during the three years of the *sukuk* issuance as the Group seeks to replace debt capital with equity. The *sukuk* therefore provides medium term bridging finance for Nakheel, and at the same time delivers what could be regarded as captive investors for any future IPO which should undoubtedly help ensure that any new equity offered is fully subscribed.

Dubai as a market for *sukuk*

As the Nakheel *sukuk* has been listed on the Dubai International Financial Exchange (DIFX) investors are able to sell their certificates at any time. The value of the certificates will depend on the rating of the issuer which reflects Nakheel's ability to meet its financial obligations, the probability of an IPO and the expected terms and the period to maturity. Assuming Nakheel is able to meet its commitments certificate holders should receive the nominal face value of their holdings in 2009 when the *sukuk* matures, but in 2007 and 2008 the market value could vary significantly from the maturity value. The major risk for *sukuk* holders is that there is a major correction in the real estate market in Dubai in 2007, and therefore a downgrading in the value of Nakheel. As there is a substantial amount of new residential and commercial property coming onto the market in 2007, estimated by some to be as much as one fifth of the total property stock, the risk of a downturn is real. However real estate analysts have made gloomy predictions in previous years, which have proved unfounded, and Nakheel itself has become more international in terms of its operations, and therefore less dependent on Dubai.

There are good prospects for a rapid expansion in *sukuk* trading on the DIFX in 2007, not least because with Gulf equity markets likely to continue to be volatile, the demand for *shariah* compliant liquid instruments with a defined maturity value is anticipated to be strong. Furthermore the Dubai Ports and Nakheel issues are only the start for high value *sukuk*, as the Dubai Islamic Bank itself has announced its intention of raising $11 billion through a *sukuk* issuance in 2007, partly to expand its ambitious expansion plans in Pakistan and elsewhere. Aldar Properties of Dubai has also announced plans for a *sukuk* worth $3.5 billion, and the Dubai Civil Aviation authority plans for a *sukuk* worth $1.64 billion.

The real test for the international credibility of the DIFX will however not come from trading local *sukuk* issuance, but rather that of Saudi companies. The Al Marasi Company of Saudi Arabia is planning a *sukuk* worth over $1 billion, which will be Saudi riyal denominated, and Aramco and Conoco Phillips of Saudi Arabia are planning United States dollar denominated *sukuk* issuance, the latter to be managed by Riyadh Bank, but it remains to be seen whether either *sukuk* will be listed and traded in Dubai. The most likely listing could be by SABIC, the Saudi Arabia Basic Industries Corporation. SABIC issued a riyal denominated *sukuk* for $800 million in 2006 which was managed by HSBC Amanah of Dubai, and it is looking to raise a further $4-6 billion through *sukuk* and Islamic financing in 2007 to part finance the construction of the Saudi Kayan Petrochemical Complex on the Gulf coast near Jubail. This will be one of the world's largest petrochemical complexes, costing over $10 billion. If some of this is financed through traded *sukuk*, this may help lower financing costs, as investors in the *sukuk* will accept a lower return if their assets are liquid. As DIFX has been accepted as a correspondent member of the World Federation of Exchanges, and since June 2006 has been an affiliate member of the International Organization of Securities Commissions (IOSCO) it has a unique status in the Gulf which should help its aspiration to become the region's preferred trading exchange.

Malaysian *sukuk* listings

While *sukuk* trading in the Gulf is new, trading in Kuala Lumpur dates back over a decade, although the market is essentially domestic, with most of the issuance local currency denominated. Rantau Abang Capital Berhad had two major *sukuk* issuances in 2006, the first being worth $790 million and the second $2.6 billion, both being managed by Malaysia's leading investment bank, CIMB. These *sukuk* were based on *musharakah* partnership structures involving profit and loss sharing. Other Malaysian *suku*k have been based on *murabahah* mark-up structures, notably that by Bank Pembangunan Malaysia worth $921 million and the *sukuk* for Putrajaya Holdings worth $578 million. Although however the Malaysia market continued to account for the largest number of *sukuk* issuances by volume, it has been overtaken in 2006 for the first time by the value of *sukuk* issuance in the United Arab Emirates. Given the issuances in the pipeline, the lead of the UAE is set to increase in 2007.

Malaysia may also lose out to other markets in 2007, notably to Singapore, which also has aspirations to becoming a centre for *sukuk* trading as part of its bid to become the international Islamic financial hub of South East Asia. Singapore is well positioned to play this role as an international financial market for conventional instruments, with most trading in United States dollar denominated securities. Singapore has only a small local Muslim community, and therefore offers little scope for Islamic retail products such as the managed *sukuk* funds offered by RHB Bank in Malaysia, but it has the potential to serve as an inter-bank market for *sukuk*. The Monetary Authority of Singapore, which has been an enthusiastic participant in several recent Islamic finance conferences, is keen to see the island play this role, as it helps diversify product offerings and attract new classes of investors, notably those who wish to be *shariah* compliant.

Malaysia's Labuan International Offshore Financial Centre also has ambitions to be a trading centre for *sukuk*, but although there are now 31 instruments listed with a market capitalization of $13.5 billion, trading is limited, and some of the issuance is of investment funds rather than Islamic notes and debt securities. Most of the listings are of Malaysian rather than international securities, and the anticipated business from nearly Brunei never materialized, the latter preferring to maintain its links with Singapore, to which its currency is pegged. Labuan is to unveil a re-branding strategy in 2007 to help boost its position, but it is unclear what its real rationale is, apart from offering tax advantages to Malaysian companies and dollar rather than Malaysian currency issuance. The government of Brunei's first ever sovereign *sukuk* in 2006, worth $96 million, was denominated in Singapore dollars and largely taken up by local banks, as well as some Gulf investors hoping that the Singapore dollar might appreciate against the United States dollar.

To date there have been no defaults on any *sukuk*, but it is likely that 2007 could see the first ever default, opening the possibility that some *sukuk* might fall into the "junk" bond category.

The prime candidates for this dubious distinction are the *sukuk* issued by Peremba Jaya Holdings valued at RM 200 million. These *sukuk* were downgraded by the Malaysian Rating Corporation (MARC) in February 2006 and there was a further downgrade in December to BBB- grade with a negative outlook. Peremba Jaya is the developer of precinct 11 in Putrajaya, but because of a weak financial position its construction subsidiary, Arif Cerah Sdn Bhd, was served with a termination notice by Putrajaya Holdings, the governmental organization managing the development. As the proceeds from the government contracts are the ultimate repayment source for the payment of the *sukuk* investors, Peremba Jaya Holdings is unlikely to be able to meet its commitments unless it can convince Putrajaya Holdings to lift the termination notice, which seems unlikely. If the *sukuk* holders take Peremba Jaya Holdings to court it should provide a precedent to determine exactly what their rights are to the underlying assets. Given the complexity of the contractual arrangements however it could take years for the legal outcome to be known.

Gulf-South East Asian links

There was much talk of increasing *shariah* compliant financial links between the Gulf and South East Asia in 2006, despite some differences in interpretation of what is acceptable under *fiqh* by the more liberal Shafii School of Islamic jurisprudence that prevails in Malaysia and Indonesia and the more conservative interpretations of *fiqh* in the Gulf. These differences did not preclude Islamic banks from the Gulf seeking to expand in South East Asia, with Al Rajhi Bank of Saudi Arabia, the largest retail Islamic bank in the world, opening nine branches in the Klang Valley surrounding Kuala Lumpur. Al Rajhi Bank was originally given a license to operate in Malaysia in 2004, but it was only two years later that its expansion plans were clarified. The issue for 2007 will be whether it can expand through organic growth; or whether it will seek to take-over an established Malaysian Islamic bank. It is not clear whether Bank Negara would permit such a foreign takeover, but loss making Bank Islam Malaysia could be a possible target, the advantage being that Al Rajhi Bank has the resources to recapitalize the bank and finance the enhancement of its customer services.

The Kuwait Finance House (KFH) also obtained a license from Bank Negara to operate in Malaysia, but so far it has focused on putting the plans in place to develop a piece of real estate it was granted by the government of Malaysia in the golden triangle in downtown Kuala Lumpur. The intention is to build luxury serviced apartments for sale to Kuwaitis and other Gulf Arabs who wish to acquire a second home in a lush tropical environment very different from the deserts of Arabia. The coming year is likely to see the start of these developments, with scheduled completion in 2009 or 2010. To finance its expansion in Asia KFH launched a Real Estate Fund in July 2006 worth $250 million to invest in both commercial and residential property, including the Kuala Lumpur project. KFH anticipates that the return to investors should be between 8 and 10 percent for the five year life of the fund. Reimbursement at the end of the five year period will be covered by the sale of the assets once construction is completed.

Not all the traffic is of course one way from the Gulf to South East Asia, as some is from the east to the west of the Indian Ocean. Maybank, Malaysia's largest conventional bank, opened an offshore unit in Bahrain in 2004. The bank offers Islamic "windows", though none have yet opened in the Bahrain branch. Of greater interest was the agreement between the Malaysian investment bank, CIMB, and Bahrain's Yusuf bin Ahmad Kanoo Holdings to distribute specialized Islamic investment products in the Gulf. These include managed equity funds and capital market instruments, as well as asset management, corporate banking and treasury services. Another significant development was the offering in April 2006 by Shamil Bank of Bahrain of its Shamil China Reality *Mudarabah*, the first ever *shariah* compliant fund focused on China. Under an agreement with Shamil Bank the Xuan Huang China Reality Investment

Fund is to invest in residential, commercial and industrial property in prime locations in Chinese cities. The *mudarabah* matures after four years, with an anticipated return to investors of 18 percent annually, which some believe may be hard to achieve despite China's booming real estate sector.

The largest link up of all involves Singapore real estate development company, CapitaLand, that is to raise $630 million through a *shariah* compliant fund. The finance is to be used for the development of a large site of 43,000 square meters of land in Bahrain, which has been designated Raffles City after the famous Singapore Hotel and boutique shopping complex. The plan is for an integrated up-market residential and retail development, in which CapitaLand will invest $800 million. However CapitaLand only intends to retain a 20 to 30 percent share in the longer run, as it is placing a major share of the assets in the *shariah* compliant fund, the aim being to attract external investment. The majority of fund subscriptions in 2007 are expected to come from the Gulf, although there may also be some indirect investment through Singapore, both from Islamic banks and *takaful* Islamic insurance companies.

Islamic Investment Banking

Most Islamic banks primarily serve the retail market, but with the development of equity markets in Muslim countries and the increase in *sukuk* issuance some have started to play an investment banking role. The Islamic financing affiliate of Commerce International Merchant Bankers Berhard, CIMB Islamic, is undoubtedly the leader in this field, as during 2006 it managed 36 *sukuk* issues, accounting for almost 30 percent of the global *sukuk* issuance, with the value of these operations exceeding $7.5 billion. CIMB Islamic investment banking business includes *shariah* advice on the structuring, documenting and trading of *sukuk* securities, as well as advice on Islamic funds and *shariah* compliant asset management. CIMB Islamic also provides Islamic debt fund services and can arrange commercial paper, medium term notes and floating rate notes using an *ijara* structure, as well as syndicated Islamic financing.

CIMB Islamic has become the most experienced provider of *shariah* compliant treasury services, with its short to medium tem facilities including negotiable Islamic debt certificates structured using *Bai Bithaman Ajil* (BBA) and Islamic Treasury Bills (i-TB) issued by the government of Malaysia. It also trades in Bank Negara Negotiable Notes with tenure of up to six months, structured on a *Bai Al-Inah* basis, as well as Islamic accepted bills, structured on the *murabahah* principle. Its activities also encompass the issuance and trading of Islamic commercial papers. It can make available to clients wanting medium to long term investment instruments Bank Negara *ijara sukuk* notes and Islamic private debt securities.

During 2006 CIMB Islamic also developed Islamic financing facilities for share purchases and trading. These *murabahah* margin financing arrangements use asset purchase and sales agreements secured on the underlying assets of the transaction. Finance is also available to finance purchases in *shariah* compliant initial public offerings (IPO's), shares made available through rights issues and preference shares, although the latter are unacceptable for most *shariah* scholars in the Gulf. Further refinement and a greater use of these facilities is likely in 2007, further strengthening the CIMB Islamic position in Malaysian capital markets.

In the Gulf international banks such as HSBC, Citigroup, Deutsche and UBS accounted for most of the investment banking business until last year, including *shariah* compliant investment banking, partly reflecting the limited capacity and experience of the local banks. However as Gulf capital markets have developed, Dubai Islamic Bank made the strategic decision to enter the investment banking arena, initially in co-operation with a new Gulf entrant rather than an existing player, Barclays Capital, an institution with much investment banking experience elsewhere, notably in Europe and South Africa. Dubai Islamic Bank subsequently became the second largest arranger of *sukuk* globally after CIMB, with issuance worth over $3 billion in 2006. It has learnt much from this exposure, and although it may be premature for it to go it alone in 2007 without an external partner, this is certainly likely in the future.

Much of this review has focused on the Gulf and South East Asia, as that is where most of the Islamic finance activity is concentrated, and will continue to be concentrated in 2007. Longer term however Iran, Pakistan, and possibly Indonesia, are likely to be much more in the news. These are all more populous countries; indeed Indonesia has the largest Muslim population in the world, although Islamic finance there remains in its infancy despite some official encouragement, with Islamic bank deposits accounting for less than one percent of the total. Iran is however the country to watch. All its banks are *shariah* compliant under its 1983 law, with Bank Melli the world's largest Islamic bank. Despite United States sanctions the Iranian economy grew by 5.4 percent in real terms in 2006, and growth is predicted to exceed 6 percent in 2007. The Islamic Republic is increasingly confident politically, and this may be matched by increasing economic confidence, including in the Islamic finance arena where it has already 23 years of experience.